

## Chapter 20 – Internal Control & Audit Tracking

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<b>20.10</b>	<b>Internal Control &amp; Auditing Policies</b>	
20.10.10	The purpose of this chapter	Jan. 1, 2004
20.10.20	Authority for these policies	Jan. 1, 2004
20.10.30	Applicability	Jan. 1, 2004
<b>20.20</b>	<b>Internal Control Policies</b>	
20.20.10	What is internal control?	Jan. 1, 2004
20.20.20	What are the basic internal control requirements?	Jan. 1, 2004
20.20.30	What are the agency's responsibilities toward minimizing risk?	Jan. 1, 2004
20.20.40	Annual certification of compliance is required	Jan. 1, 2004
20.20.50	What internal control documentation is required?	Jan. 1, 2004
20.20.60	Answers to some common questions about internal control	Jan. 1, 2004
20.20.70	More about control activities	Jan. 1, 2004
<b>20.30</b>	<b>Suspected Losses of Public Funds or Property</b>	
20.30.10	Why loss procedures are important	Jan. 1, 2004
20.30.20	What are the procedures an agency should follow upon suspicion of a loss?	Jan. 1, 2004
<b>20.40</b>	<b>Internal Auditing Policies</b>	
20.40.10	Why internal audit?	Jan. 1, 2004
20.40.20	What is internal auditing?	Jan. 1, 2004
20.40.30	What are the differences between internal and external auditing?	Jan. 1, 2004
20.40.40	What are the basic requirements of internal auditing?	Jan. 1, 2004

## **20.50      Audit Tracking**

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20.50.10	Office of the State Controller responsibilities for audit resolution tracking	Jan. 1, 2004
20.50.20	Agency responsibilities for audit resolution tracking	Jan. 1, 2004
20.50.30	Audit Tracking Information Report format	Jan. 1, 2004

## **20.10**

### **Internal Control & Audit Tracking Policies**

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#### **20.10.10      The purpose of this chapter**

This chapter provides agency heads and directors, internal control officers, internal auditors, and other agency staff with a background and approach to establishing and maintaining an effective system of internal control and audit so as to reasonably assure that they are meeting their respective missions and objectives. The Internal Control Guide developed by the Office of the State Controller provides specific guidance to meet the requirements of Title 5, Chapter 143, Section 1541, Subsection 10 – A.

The internal control policies are based on the report issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), standards adopted by enactment of Chapter 451, Public Laws of 2003, a comprehensive policy and procedures manual issued by the State Controller in September of 2004, and standards recently adopted by the American Institute of Certified Public Accountants and the federal Office of Management and Budget. The policies on internal auditing are derived from the Institute of Internal Auditors and the federal General Accounting Office.

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#### **20.10.20      Authority for these policies**

The authority for these policies is Title 5, Chapter 143, Section 1541, Subsection 10-A.

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#### **20.10.30      Applicability**

This chapter is applicable to and binding on all agencies of State government, unless otherwise exempted by statute.

## 20.20

### Internal Control Policies

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#### 20.20.10 What is internal control?

Internal control is a management process for keeping an entity (agency, board, commission, department, division, institution, or program) on course in achieving its organizational objectives. A management control system, including comprehensive internal controls, should provide reasonable assurance that entity objectives are being met.

Entity objectives fall into the following three separate but related categories:

- Effectiveness and efficiency of operations,
- Reliability of financial reporting,
- Compliance with applicable laws and regulations.

Control objectives focus the management control system toward those control activities designed to minimize the risks of not achieving entity objectives. Safeguarding of assets is an example of a control objective that, when in place and effective, aids in the achievement of all three entity objective categories.

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#### 20.20.20 What are the basic internal control requirements?

- 20.20.20.a Each agency is responsible for establishing and maintaining an effective system of internal control throughout the organization as required by Title 5, Chapter 143, Section 1541, Subsection 10-A.
- 20.20.20.b An internal control system should provide *reasonable assurance* that an organization will accomplish its objectives. The concept of reasonable assurance recognizes that the cost of an internal control activity should not exceed the benefit derived there from. Reasonable assurance equates to a satisfactory level of confidence given considerations of costs, benefits, and risks.
- 20.20.20.c Agency management must identify and analyze the risks to achieving entity objectives and then determine how those risks should be managed. Management defines the level of risk that the organization is willing to accept and strives to maintain risks within those levels.

- 20.20.20.d Each agency is to adopt methods to assess risk and review control activities. The methods developed should address the specific needs of the agency.

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**20.20.30 What are the agency's responsibilities toward minimizing risk?**

- 20.20.30.a The internal control officer has the ultimate responsibility for establishing, maintaining, and reviewing the system of internal control in the agency. The agency director should designate one individual, with sufficient authority to carry out assigned responsibilities, as the internal control officer. (Normally, this would be a senior agency manager who does not serve in the internal audit function.)
- 20.20.30.b The **internal control officer** has the responsibility for coordinating and scheduling the overall agency-wide effort of evaluating and reporting on reviews and improving control activities in conformance with this policy. This person is to provide assurance to the agency director that the agency has performed the required risk assessments and the necessary evaluative processes. This communication may be ongoing, but at least once per year, this assurance must be made in writing to the State Controller.
- 20.20.30.c The **manager of each organizational unit** and any other components within an agency is responsible for internal control in that unit.
- 20.20.30.d Management should make it clear that **agency staff** have explicit or implicit control activity duties including delivery of services to the public; producing information for the management control system; maintaining financial information; and inspecting or maintaining physical assets. In addition, agency management should encourage agency staff's open communication with higher levels within the agency regarding problems in operations, non-compliance with codes of conduct, violations of policy, and illegal acts.
- 20.20.30.e Agencies have the flexibility to assign appropriate staff to complete the risk assessments and internal review of control activities required by this policy. This staffing may include those directly responsible for the system from first line supervisor on up, and also may include the internal auditor or other similarly qualified individual or contractor.

All agencies, regardless of size, are to make adequate provision for periodic risk assessments and, as applicable, reviews of control activity procedures.

An agency internal auditor, if available or the Office of the State Controller's Internal Control Specialists may provide technical assistance to the manager of an organizational unit in developing appropriate procedures to conduct risk assessments and internal reviews of control activities.

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**20.20.40****Annual certification of compliance is required**

Annually, each agency director and chief financial officer shall sign and submit a Financial Disclosure Certificate to the Office of the State Controller. This certificate will report the results of the agency's compliance with this policy, including an attached summary description of material internal control weaknesses, if any, and a brief corrective action plan.

This certificate is provided to agencies annually in Section 90.30 of this manual. It is due each year by the date specified in those instructions.

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**20.20.50****What internal control documentation is required?**

Agencies are to maintain adequate written documentation for activities conducted in connection with risk assessments, internal review of control activities and follow-up actions. These activities, as completed, should be documented no later than June 30, 2004 as required by Title 5, Chapter 143, Section 1541, Subsection 10-A. The risk assessment methods documented should address at minimum: identification, review, and management of risks that affect entity objectives including control objectives such as safeguarding State assets and resources. This documentation includes any checklists and methods used to complete these activities. The internal control officer is responsible for ensuring that the required documentation is maintained and available for review by agency management, the State Auditor, the State Controller, and the Commissioner of Administrative and Financial Services.

**Please refer to the Internal Control Guide and Internal Control Standards to help with complying with the documentation requirements.**

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**20.20.60****Answers to some common questions about internal control**

Answers to some common questions about internal control are presented below.

**20.20.60.a****What is a risk assessment?**

A risk assessment is an ongoing process to identify, analyze, and manage risk. An agency needs a plan to identify both external and internal risks. The plan will help management understand how those risks affect their activities, assess their significance, manage their effect, and provide for continuous monitoring. Risk identification can often be integrated with an organization's planning activities.

- External risks arise from activities outside the agency. Technological developments, changing public expectations, legislative directives, natural catastrophes and economic changes all have the potential for creating external risks in an agency.
- Internal risks are less predictable and arise from activities inside the agency. Disruption of the central computer system or telephone system causes obvious operational problems. When a new agency director is appointed, changes in management style can affect internal control objectives.

**20.20.60.b****How does an agency identify risks?**

Identification of risks can start from existing systems. The budget process, audits, strategic planning, and other chapters included in this manual all provide opportunities for managers to conduct quantitative and qualitative reviews and to identify and prioritize risks. More informal opportunities include senior management planning meetings, meetings with management analysts or auditors, and everyday interaction with staff.

More important than the specific method used to identify risks is management's careful consideration of factors unique to the agency. Some key factors, such as an agency's past experience in failing to meet objectives, staff quality, statutory framework, or the significance and complexity of activities in relation to the agency's mission, should receive management's careful consideration.

By analyzing organizational activities, managers apply risk assessment to functions. Successfully managing risk at the activity level is integral to maintaining an acceptable level of risk for the organization.

20.20.60.c

**What is risk analysis?**

Risk analysis involves a careful, rational process of estimating the significance of a risk, assessing the likelihood of its occurrence and considering what actions and controls need to be taken to manage it. Risk analysis also involves estimating the cost to the agency if something does go wrong. That analysis is based on the agency's assumptions about the risk and costs associated with reducing it. Sometimes an actual risk may appear to require one set of actions, but the perceived risk coupled with media reaction to that risk, requires a more expensive set of actions.

It is also important to recognize the distinction between risk assessment (a part of a management control system) and actually managing risk (part of an organization's operations). Limitations on resources will define the level to which risks can be managed.

20.20.60.d

**How does an agency control or minimize risk?**

Control of risk starts with management deciding on the actions necessary to reduce the potential occurrence and significance and then monitoring conditions to remain aware of changing circumstances. Management tools for an early warning system include information systems and ensuring appropriate data are captured, processed, and reported.

If an agency builds the components of a management control system into its planning efforts as well as its daily activities, it is more likely to avoid unnecessary costs; make quick responses as needs arise; and adapt to decreasing resources and changing political and economic climates. The five components of good internal controls within a management control system are:

- **Control Environment** – The control environment sets the tone of an organization. It influences the control consciousness of its people and it is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the integrity, ethical values, and competence of the entity's staff; management's philosophy and operating style; the way management assigns authority and responsibility; the way management organizes and develops its staff; and the attention and direction provided by the legislature, board, committee, commission, authority, etc.
- **Risk Assessment** – Every entity faces a variety of risks from external and internal sources, all of which must be assessed. A precondition to risk assessment is establishment of objectives, linked at different levels and internally consistent. Risk assessment is the identification and analysis of relevant risks to achieving the objectives and forms a basis



for determining how the risks should be managed. Because economic, industry, regulatory, and operating conditions will continue to change, mechanisms are needed to identify and deal with the special risks associated with change.

- **Control Activities** – Control activities are the internal policies and procedures that help ensure management directives are carried out. They help ensure necessary actions are taken to address risks to achieving the entity’s objectives. Control activities occur throughout the organization, at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliation, review of operating performance, security of assets, and segregation of duties. (Refer also to Subsection 20.20.70.)
- **Information and Communication** – Pertinent information must be identified, captured, and communicated in a form and time frame that enables people to carry out their responsibilities. Information systems produce reports containing operational, financial, and compliance-related information, making it possible to run and control the entity. Information systems deal not only with internally generated data, but also with information about external events, activities, and conditions necessary to both informed business decision-making and external reporting.

Effective communication also must occur in a broader sense, flowing down, across, and up the organization. All personnel must receive from top management a clear message that control responsibilities must be taken seriously. Also, all personnel must understand their own role in the management control system, as well as how individual activities relate to the work of others. Additionally, staff members must have a means of communicating significant information upstream.

Effective communication is also essential with external parties, such as customers, suppliers, regulators, and stakeholders.

- **Monitoring** – Management systems and internal activities need to be monitored to assess the quality of their performance over time. Assessment is accomplished through ongoing monitoring activities, separate evaluations, or a combination of the two. Ongoing monitoring occurs in the course of operations, including regular management and supervisory activities and other action personnel take in performing their duties. The scope and frequency of separate evaluations will depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures. Deficiencies should be reported

upstream, with serious matters reported to top management.

20.20.60.e

**Do control activities increase staffing requirements?**

Although control activity procedures are not intended to increase staffing levels, acceptable procedures are to be established and followed which may require changes in existing workloads and/or additional staff position(s). However, a periodic thorough internal review of control activities may identify policies and procedures that are no longer required. It is recognized that some small to medium size operations may not be able to institute internal control procedures on the same level as larger, more complex agencies. In those cases where staffing may prohibit or restrict the appropriate segregation of duties, management must either have more active oversight of operations or utilize personnel from other organizational units to the extent possible as compensating controls.

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**20.20.70**

**More about control activities**

The control activities presented in this subsection are intended to provide agency directors, internal control officers, internal auditors, and other agency staff with an overview. This subsection does not place any requirements or expectations on the agency.

**Comprehensive information and guidance may be found in the OSC's Internal Control Guide.**

20.20.70.a

Control activities are actions taken to minimize risk. The need for a control activity is established in the risk assessment process. When the assessment has identified a significant risk to the achievement of an objective, a corresponding control activity should be determined. If control activities are in place for each significant agency operation and if management makes sure those activities are carried out properly, staff can be reasonably confident the management control system will provide the necessary assurances.

Control activities and procedures should be considered to ensure the organization is in compliance with the *State Administrative & Accounting Manual*, Title 5, and other applicable accounting standards. Generally, these activities and procedures may be categorized into one of the following areas and completed by personnel at various levels:

- **Direct functional or activity management reviews** - reviews should assess specific functions or activities. The reviews may focus on compliance, financial, or operational issues.

- **Information processing** - A variety of control activities should be performed to check the accuracy and completeness of information as well as the authorization of transactions. Development of new systems, and changes to existing ones should be controlled. Additionally, access to programs and data should be restricted.
- **Physical controls** - Equipment, inventories, securities, cash, and other assets should be secured physically, and periodically counted and compared with amounts shown on control records.
- **Operating Indicators** - Certain operating results can be anticipated. By investigating unexpected results or unusual trends, circumstances that jeopardize the achievement of objectives can be identified.
- **Segregation of duties** - Duties are divided, or segregated, among different people to reduce the risk of error or inappropriate actions. For example, responsibilities for authorizing transactions, recording them, and handling the related assets should be separated.

20.20.70.b

**What are some potential limitations of control activities?**

Control activities, no matter how well designed and executed, can provide only reasonable assurance regarding achievement of objectives. The likelihood of achievement is affected by limitations inherent in all control systems. These limitations include the following:

- **Judgment** - The effectiveness of controls will be limited by the fact that decisions must be made with human judgment in the time available, based on information at hand, and under the pressures to conduct business.
- **Breakdowns** - Even if control activities are well designed, they can break down. Personnel may misunderstand instructions or simply make mistakes. Errors may also stem from new technology and the complexity of computerized information systems.
- **Management override** - Even in effectively controlled organizations, high level personnel may be able to override prescribed policies or procedures for personal gain or advantage. This should not be confused with management intervention, which represents management actions to depart from prescribed policies or procedures for legitimate purposes.

- **Collusion** - Collusion between two or more individuals can result in control failures. Individuals acting collectively often can alter financial data or other management information in a manner that cannot be identified by the control system.
- **Costs versus benefits** - In determining whether a particular control activity should be established, the risk of failure and the potential effect must be considered along with the cost of establishing the control. Excessive control is costly and counterproductive. Too little control presents undue risk. Agencies should make a conscious effort to strike an appropriate balance.

## **20.30**

### **Suspected Losses of Public Funds or Property**

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#### **20.30.10 Why loss procedures are important**

In the event of the suspected loss of public funds or property, it is important that correct procedures are followed to:

- Minimize the loss;
- Ensure that investigations are facilitated and not impeded;
- Ensure that only prudent settlements are made;
- Ensure that bond claims are protected;
- Ensure that only appropriate personnel actions are taken;
- Comply with Title 5, Chapter 11, Section 244-A to report losses to the State Auditor; and,
- Comply with Title 5, Chapter 143, Section 1541, Subsection 10-A to report losses to the State Controller.

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#### **20.30.20 What are the procedures an agency should follow upon suspicion of a loss?**

Each agency should follow the appropriate procedures outlined in this section. Additionally, each agency should establish formal procedures to notify appropriate agency personnel when someone suspects a loss of public funds or property.

20.30.20.a Appropriate personnel not involved in the suspected loss should be notified prior to contacting the outside agencies. This may include the agency head or deputies, chief financial officer or internal auditor depending upon the circumstances.

20.30.20.b The agency's Assistant Attorney General (AAG) should be consulted on incidents involving the loss of public funds or property, when the nature or facts of the incident warrant such discussion for the purpose of acquiring legal advice. It is best to establish, in advance and in writing, with the agency's assigned AAG appropriate general procedures to follow upon learning of a loss of public funds or property.

- 20.30.20.c Report the suspected loss immediately to the State Controller and State Auditor using established agency procedures.
- 20.30.20.d Report the suspected loss to the Division of Risk Management, Department of Administrative and Financial Services.
- 20.30.20.e If the suspected loss involves the health or safety of State employees or property or the agency is so advised either by the Attorney General's Office contact the appropriate local or State law enforcement officials.
- 20.30.20.f Protect any pertinent records from destruction.

## **20.40**

### **Internal Auditing Policies**

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#### **20.40.10 Why internal audit?**

An internal audit function aids management by improving the quality of the control environment (see Subsection 20.20.60.d). These internal auditing policies should provide agency directors, internal control officers, internal auditors, and other agency staff with a background and approach toward the establishment of an effective internal audit function, as appropriate.

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#### **20.40.20 What is internal auditing?**

Internal auditing is an independent appraisal activity established within an agency for the review of operations as a service to management. The objective of internal auditing is to assist agency staff in the effective discharge of their responsibilities.

Internal auditors examine and evaluate the planning, organizing, and directing processes to determine whether reasonable assurance exists that the agency will achieve its goals and objectives. Such evaluations, in the aggregate, provide information to appraise the agency's overall control system and the quality in implementing assigned responsibilities. All systems, processes, operations, functions, and activities within an agency are subject to evaluations by internal auditors.

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#### **20.40.30 What are the differences between internal and external auditing?**

Internal and external audits are different in the following respects:

- 20.40.30.a Internal auditors are employees or contractors providing internal auditing services in a specific governmental unit.
- 20.40.30.b External auditors are independent of the governmental unit. External auditors must be independent both in fact and in appearance.

External auditors include:

- State Auditor.

- Government auditors who are members of a government other than the State of Maine.
- Independent public auditors who provide auditing services on a fee basis.
- Auditors of legislative organizations such as the OPEGA.

20.40.30.c External audits do not alleviate the need for an internal audit function, and vice-versa. Internal and external audit functions are complementary. Agencies are not to rely solely on audits performed by outside parties to measure the appropriateness and degree of internal activities. Audits by external agencies, such as the OPEGA and the State Auditor, are not intended to replace an ongoing management review of operations and may in fact be limited by law in the scope of the examination they may perform. This limit on the scope may preclude a comprehensive review of an agency's internal procedures.

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## **20.40.40 What are the basic requirements of internal auditing?**

20.40.40.a An internal audit program should be made based on the results of a risk assessment and the prioritization of the agency's other programmatic needs.

Internal audit programs implemented by agencies should follow auditing standards as appropriate for the agency or program (i.e. Generally Accepted Government Audit Standards or Institute of Internal Auditor Standards).

20.40.40.b Internal auditing is to:

1. Review operations or programs to ascertain whether results are consistent with established goals and objectives and whether the operations or programs are managed according to plan.
2. Review the management control system designed to ensure compliance with those policies, plans, procedures, laws, regulations, and contracts that could have a significant impact on operations. Also report whether the management control system is working as designed.
3. Review the reliability and integrity of financial and operating information and the means used to identify, measure, classify, and report such information.
4. Review the means of safeguarding assets and, as appropriate, verify the



existence of such assets.

5. Appraise the economy and efficiency with which resources are employed.
6. Isolate problem areas and provide a means for corrective action before the problem affects operational efficiency.
7. Promote open communications and establish a positive relationship among the internal auditor, external auditor, agency staff, management, audit committee, and board/committee/commission members as applicable.

20.40.40.c

The internal control function of the Office of the State Controller is an integral part of the State of Maine's efforts to improve financial management and accountability. It serves to promote objective, comprehensive review coverage and to assure the consideration of audit recommendations.

To accomplish this, the internal control function within the Office of the State Controller is responsible to the State Controller with sufficient authority to promote independence and to ensure broad audit coverage, adequate consideration of audit reports, and appropriate action on audit recommendations.

Agency based internal auditors should also be independent of the activities they audit by having no direct or indirect authority or responsibility for the programs or operations they audit. Generally, reports and associated audit findings, recommendations, and analyses are directed to the agency head, or chief executive officer.

20.40.40.d

Internal audits may be performed during or after a fiscal period. In either case, an audit is not part of any control activity; however it serves as an important component of the management control system.

The activities of an internal audit, whether performed during or after a fiscal period, may include:

- Consultation and education sessions to familiarize agency staff with control activity responsibilities,
- Assisting agency staff in preparing for new processes or requirements, Reviewing agency activities to serve as a basis for recommending improvements as necessary to aid in the accomplishment of agency identified goals and objectives.

## 20.50.10

### Audit Tracking

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#### 20.50.10 Office of the State Controller responsibilities for audit resolution tracking

The Office of the State Controller has the following responsibilities related to the State Auditor's exception to specific expenditures incurred by an agency or other practices related in any way to the agency's financial transactions, i.e. audit findings and questioned costs.

1. The State Controller has a duty to cause corrective action to be taken within a timeframe determined by the Controller to be in the best interest of the State, such action to include, as appropriate, notifying the Commissioner of Administrative and Financial Services, the Governor, and the appropriate legislative oversight committee.
2. Upon notification by the State Auditor report the status of the resolution of audit findings and recommendations to the appropriate committees of the Legislature in accordance with the requirements placed upon the State Auditor in Title 5, Chapter 11, Section 244-A:

*"By September 15th of each year, the State Auditor shall schedule a meeting with each joint standing committee of the Legislature having jurisdiction over those departments or agencies in the audit of which the State Auditor has identified findings and the joint standing committees of the Legislature having jurisdiction over appropriations and financial affairs and State and local government matters. The State Auditor shall present an assessment of findings and recommendations of the most recently completed audit performed pursuant to this section, including, but not restricted to, questioned costs and material weaknesses of State programs. The State Auditor shall notify affected State agencies and applicable State central service agency officials, such as, without limitation, the State Controller, State Budget Officer, State Purchasing Agent and Chief Information Officer, of the meeting time and place."*

The State Controller's audit resolution report shall include actions taken as a result of an audit finding including, but not limited to, types of personnel actions, costs and types of litigation, and value of recouped goods or services.

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**20.50.20      Agency responsibilities for audit resolution tracking**

20.50.20.a      To provide the Office of the State Controller with the necessary information to fulfill its responsibilities, and to cause corrective action to be taken in a timely manner, all State agencies and institutions are required to submit, to the State Controller within 30 days after the finding is officially communicated to the agency, final corrective action plan information for each finding or questioned cost contained in the State audit. Refer to Subsection 20.50.30 for the format of the information to be provided.

For findings reporting fraud, the information submitted is to include, fraud amount; costs and type of litigation; recovery to date; and personnel actions taken.

20.50.20.b      Further, to provide the Office of the State Controller with information necessary to complete annual State and federal reporting requirements, agencies are required to report, upon request from the State Controller, on the current status of audit resolution.

20.50.20.c      Audit tracking information is not required to be submitted for audits with no findings or questioned costs.

**STATE OF MAINE AUDIT FINDING  
CORRECTIVE ACTION PLAN INFORMATION**

State Agency No.:

State Audit No.:

Finding No.:

Auditor Recommendation:

Corrective Action Taken or To Be Taken:

If Already Taken, Date Completed:

If Still To Be Taken, Estimated Completion Date:

If Auditee Disagrees With Finding, Reason(s) Why:

Auditee Representative Responsible To See Corrective Action Taken:

Name:

Phone Number:

E-mail Address:

Address: